No. 88-955

Supreme Court, U.S.
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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
VS.
MERIT LIFE INSURANCE COMPANY.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether, in connection with the sale of indemnity reinsurance, "ceding commissions" payable by a reinsurer to the initial insurer are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 853 F.2d 1435. The memorandum opinion of the Tax Court (Pet. App. 25a-30a) is unofficially reported at 52 T.C.M. (CCH) 658.

JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on August 11, 1988. The petition for a writ of certiorari was filed on December 8, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. Respondent is an Indiana corporation engaged primarily in the business of writing and reinsuring life insurance policies. During the years in question, it qualified for federal income

taxation as a life insurance company under Section 801 of the Internal Revenue Code.[1]

There are two general types of reinsurance: indemnity reinsurance (also known as coinsurance) and assumption reinsurance. At issue in this case is the tax treatment for ceding commissions in indemnity reinsurance transactions. Indemnity reinsurance is a method by which a life insurance company (the reinsurer or reinsuring company) indemnifies another life insurance company (the ceding or reinsured company) against all or a portion of its risk exposure under one or more insurance policies. In other words, the ceding company transfers some or all of the risks it has underwritten to the reinsurer. The ceding company reduces its reserves attributable to the transferred liabilities, and the reinsuring company increases its reserves to cover the acquired risk. Pet. App. 2a, 26a-27a.

In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policy holders. No relationship, contractual or otherwise, exists between the reinsurer and the policy holders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange, the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission. Pet. App. 2a, 26a.

In contrast, assumption reinsurance involves the purchase of a block of insurance policies by the reinsurer from the original insurer at which point the reinsurer assumes *all* of the original insurer's risks and obligations and becomes directly liable to the policy holders. The original insurer is then relieved of all liability

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1973-1975, the years at issue (the "Code").

under the policies and the policy holders are informed that henceforth they are insured by the reinsuring company and all future premiums are to be paid and claims made to the reinsurer. The reinsurer pays all future claims, commissions, expenses and taxes. In addition, the reinsurer assumes the entire reserve liability, thereby reducing the ceding company's reserve liability. The purchase price is normally greater than but includes a commission to the selling company. The reinsurer simply purchases the policies and steps into the shoes of the ceding or selling company. Pet. App. 3a.

During the years 1973 through 1975, respondent entered into five indemnity reinsurance agreements as reinsurer with respect to five separate blocks of life insurance policies written by American General Life Insurance Company.[2] Under these agreements, respondent agreed to reinsure specified percentages of the five blocks of policies issued by American General. Pet. App. 3a.

Three of the agreements in this case were "conventional" coinsurance agreements. Two of the agreements were "modified" coinsurance agreements, under which American General continued to maintain the reserves on the reinsured policies.[3] The ceding commissions on the foregoing agreements were either paid

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[2] Four of the blocks of reinsured policies were originally issued by American General Life Insurance Company of Delaware, and the fifth block was initially issued by American General Life Insurance Company of New York. Pet. App. 3a-4a. Both original insurers are referred to hereinafter as "American General."

[3] Modified coinsurance is a type of coinsurance which differs from conventional coinsurance in that the ceding company retains the reinsured assets, continues to carry the reserves on its books and collects any investment income derived from assets supporting the reserves. However, if the parties consent under Section 820(a) of the Code, the ceding company's retention of assets and corresponding reflection of reserves are treated for tax purposes as being merely custodial for the reinsuring company's behalf. Consequently, the same transfer of reserves from the ceding company to the reinsuring company takes places as in conventional coinsurance. Although two of the transactions herein were modified coinsurance transactions, the parties made the applicable consent under Section 820(a) of the Code; for tax purposes, then, the same

outright by respondent to American General or retained by American General. Pet. App. 4a at n.2, 27a-29a. The ceding commissions for the five transactions aggregated $1,414,467, $898,213 and $2,014,899 for the years 1973, 1974, and 1975, respectively. Pet. App. 28a-29a. Each of the agreements provided that American General could recapture the reinsured policies on specified future dates. Pet. App. 4a.

2. On its corporate income tax returns for 1973-1975, respondent deducted the full amount of the ceding commissions in the years of payment. The Commissioner disallowed the deductions claimed for the ceding commissions. The Commissioner contended that the ceding commissions should be capitalized and amortized over the estimated lives of the agreements (which ranged between 57 and 64 months). Pet. App. 4a-6a.

Respondent filed a petition in the Tax Court seeking redetermination of the alleged deficiencies, and the Tax Court ruled in its favor. Pet. App. 25a-30a. Declining to reconsider its prior decision in *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions paid to the initial insurer in an indemnity reinsurance transaction may be deducted in full in the year of payment as "return premiums [or] *** other consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Code. Pet. App. 29a-30a.

3. The court of appeals affirmed. Pet. App. 1a-23a. Noting its disagreement with the Eighth Circuit's decisions in *Modern American Life Ins. Co. v. Commissioner*, 818 F.2d 1386 (1987), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (1987), and with the Fifth Circuit's decision in *Colonial American Life Ins. Co. v. Commissioner*, 843 F.2d 201 (1988), cert. granted, No. 88-396 (Dec. 5, 1988) (Pet. App. 11a-15a), the court held that the ceding commissions in this case were currently deductible. The court of appeals thus accepted the distinction between indemnity reinsurance transactions and assumption reinsurance transactions provided by the Code and subscribed to by the Tax Court, concluding that ceding commissions paid pursuant

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results obtain as if conventional coinsurance had been used. Pet. App. 27a at n.3.

to indemnity reinsurance agreements, like agents' commissions paid pursuant to the issuance of a new insurance policy, were intended by Congress to be currently deductible. Pet. App. 13a-14a. The court concluded that the "differences [between assumption and indemnity reinsurance] substantially outweigh the similarities," and that different tax treatment of the two kinds of transactions is therefore proper. Pet. App. 15a.

REASONS FOR NOT GRANTING THE PETITION

The Petition of the government for a writ of certiorari in this case asks that plenary review of this case not be granted but asks rather that the Court hold this case in abeyance pending the outcome in *Colonial American Life Ins. Co. v. Commissioner,* cert. granted, No. 88-396 (Dec. 5, 1988), a case which presents the same question which is presented in this case. Granting the government's Petition in this case would be manifestly unfair to respondent due to the government's tactics in handling this Petition, as shown below. Consequently, respondent asks that the government's Petition be denied. If certiorari is to be granted in this case, respondent asks that this case be subject to plenary review rather than *Colonial,* or alternatively, in conjunction with *Colonial.*

DISCUSSION

The government has manipulated the timing of the appellate process of this Court in *Colonial* and in this case to prevent respondent from participating in the decision by the Court to grant certiorari for the issue involved in this case, and is now attempting by its Petition herein to prevent respondent from arguing the issue involved herein before this Court. The government's Petition herein is part of its attempt to choose *Colonial* as the case which will be argued before this Court, rather than this case, although the issue in both cases is the same. The way in which the government has so manipulated this Court's appellate process is shown by the history of the within case and of *Colonial* as set forth below.

History of Certiorari Petition in This Case. The judgment in favor of respondent in the within case was entered in the U.S. Court of Appeals for the Seventh Circuit on August 11, 1988. The government therefore had until November 9th (all dates referred to herein are in 1988 unless otherwise indicated) to petition for a writ of certiorari.

However, on October 28th, the government, on an ex parte basis, sought an extension of its time to so petition. The extension was granted on November 1st. The only reason cited by the government in its application for this extension was that the extension was needed to permit the Solicitor General to "coordinate his decision in this case with the government's response to the pending petition for certiorari" in *Colonial.* Respondent was not notified prior to the government's ex parte action of the government's intent to seek such an extension. In fact, respondent did not receive and therefore become informed of the extension application until November 2nd, the day after the extension had been granted. The government was given until December 9th to petition for a writ of certiorari in the within case.

History of Government's Response to Colonial Petition for Certiorari. Prior to its application to extend its time to petition in the within case, the government had twice obtained extensions of time to respond to the petition of Colonial American Life Insurance Company to this Court for certiorari, which petition was filed August 22nd. The reason the government sought the delay in *Colonial* was based on its need to determine whether a conflict existed between the Fifth Circuit Court of Appeals decision in *Colonial* (843 F.2d 201) and the decision of the Seventh Circuit Court of Appeals in the within case. The government's response was finally due in *Colonial* on November 15th. It was on that date that the government filed its papers agreeing with the *Colonial* petition for certiorari on the basis of the conflict with the Seventh Circuit's decision in this case.

Effect of Colonial Certiorari on This Case. As shown from the foregoing examination of the government's actions in *Colonial,* and in the within case, the government knew on November 15th, when it agreed to the certiorari petition in *Colonial,* that it would seek certiorari in the within case. It also knew that only the

respondent herein had reasons for raising any arguments against the Court's choosing to review the issue presented by these cases at this time. Nevertheless the government took full advantage of the ex parte extention this Court granted the government and delayed filing for certiorari in the within case.

On December 5th, the Court granted the *Colonial* petition for certiorari. The government in its Petition herein, filed three days later on December 8th, has now asked the Court to hold respondent's case in abeyance and hear only *Colonial*. Because certiorari has been granted in *Colonial*, the respondent has been prevented, by the government's delay in this case, from raising the valid arguments which exist against granting certiorari in either of these cases. It is respondent's position that plenary review is proper in neither *Colonial* nor this case because of the extremely narrow issue involved which affects only life insurance companies which sell reinsurance. Further, this issue is presently before the U.S. Court of Appeals for the Ninth Circuit. *Oxford Life Ins. Co. v. United States*, No. 88-2295 (9th Cir.). This Court should not review a case presenting a narrow issue such as this which has not yet been fully subject to appellate court analysis.

Effect of Timing of Petition Herein. By means of its Petition filed herein, given the fact that it was filed after the *Colonial* certiorari decision had been made by both the government and the Court, the government is seeking to select the opponent it prefers to face in presenting the issue involved herein to the Court. The Court and the respondent herein should have a role in the process of determining which case goes before the Court. If the government's Petition herein is granted, respondent will be prevented from presenting its case to the Court, a case which respondent has successfully presented in the lower courts. The government will be allowed to select the *Colonial* case to present to the Court, which it has successfully presented in a lower court. The Court should not allow the government to select its opponent, or to benefit so greatly from the ex parte extension granted in good faith by the Court in this case based upon the government's stated need for such extension, *i.e.*, to coordinate this case with *Colonial*, when such need clearly ceased to exist on November 15th.

The government could have and should have filed a petition for plenary review in this case on November 15th in conjunction with its agreement to certiorari in *Colonial*. Respondent would then have had a forum to present its arguments against certiorari in these cases, and, if unsuccessful in such arguments, to present its arguments on the merits of this case to the Court. The government's delay in filing the Petition herein beyond November 15th was unjustified. Only the government's continued unjustified delay beyond December 5th, the date of the Court's certiorari decision in *Colonial*, has allowed the government to request the disposition of this case which is set forth in its Petition, which would prevent respondent from arguing either the certiorari question or the substantive question involved herein before the Court. Consequently, this Petition should be denied. In light of the fact that certiorari has been granted in *Colonial*, respondent recognizes that it is unlikely that such denial will be granted. Therefore, in the event such denial is not granted, respondent asks this Court to grant plenary review in this case rather than in *Colonial* so that respondent, for the reasons set forth above, may have an opportunity to present its case to this Court. It should be noted that although certiorari has been granted in *Colonial*, no briefs have been filed in that case. It is believed that the petitioner's brief in *Colonial* is not due until after January 15, 1989. Alternatively, respondent asks that plenary review be granted in both cases.

CONCLUSION

The petition for a writ of certiorari should be denied. If it is not denied, plenary review of this case rather than *Colonial* should be granted. Alternatively, plenary review should be granted in both cases.

Respectfully submitted,

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December 1988